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Recycle, reduce and reflect:
Information overload and knowledge deficit in the field of foreign investment and the law

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Introduction

Much of my recent research has focused on two questions. First, I have asked whether the nature of host state legal systems is important to foreign investors: is it a determinant of their decisions as to where to locate? Although the dominant theory, led by the World Bank, vigorously asserts that the legal system is very important, my research has shown that this not always the case. Second, I have asked what kind of legal system a foreign investor might be looking for. The dominant theory argues strongly that investors seek legal systems in which limited discretion is given to bureaucrats and corruption is low. But foreign investors are concerned with achieving high predictability and low cost, and I have found that some investors believe these features can be achieved in high discretion and high corruption environments (See Perry-Kessaris, 2004 and 2003; and Perry, 2001).

In the course of this research, it has become clear to me that the World Bank is subjecting empirical researchers and policy makers in this field to a paradoxical combination of information overload and knowledge deficit. In this paper I review World Bank practice in this field to demonstrate that there is great value first, in recycling data such as that produced by the Bank, by which I mean using the data to test new hypotheses, or indeed to confirm the conclusions drawn by the original analysts. However, to meet this objective, the data must be transparent and accessible. Second, there is value in reducing methodological

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complexity. Third, I argue that there is value in reflecting before we adopt the conclusions of others.

Recycle

It is tempting to create new data sets. It is exciting to be credited with something new, and it often appears easier than trying to understand and master the work of others. But it is important first to consider what data already exist. In the field of foreign investment and the law, we suddenly have rather a lot.

Early empirical forays into the field of foreign investment determinants were thin and narrow—often 'based on surveys of international experts' and producing 'a single score for each country'. Later, efforts were made to broaden and deepen the focus, using aggregate indicators such as rule of law, corruption and 'legal origins.' But aggregate indicators and cross-country regressions give only 'limited insights into the heterogeneity of institutional arrangements' among and within host states, and into 'the impact of those arrangements on the investment decisions of different types of firms.' So the World Bank was prompted to collect 'more disaggregated evidence' about legal systems and to find new ways to 'trace' their impact on 'the investment decisions and performance of firms' (World Bank, 2004a, p. 21).

Today, the Bank produces three main sets of indicators about national legal systems.[1] The World Bank Institute publishes *Governance Indicators* measuring 'the traditions and institutions by which authority in a country is exercised'. Each governance indicator is a composite of up to 13 polls of experts and/or cross-country surveys. Data from the polls and surveys are converted by a panel of experts to composite indicators of six aspects of governance, such as rule of law

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[1] Other data sets do exist but are not given much attention and are rarely of interest to those who focus on foreign investment. For example, the Civic Engagement Group of the Social Development Department of the World Bank is seeking to benchmark the 'enabling environment' for civic engagement in development processes (Thindwa et al., 2003, p. 2).

and corruption, in over 150 countries. The Rapid Response Unit produces a further two sets of data. Its *Doing Business* indicators are collected by local legal professionals who measure factors such as the time and cost of starting a business and obtaining a license in respect of fictitious cases. The resulting picture is a relatively objective view of legal systems (World Bank, 2004a, pp. 9-14). Its *Enterprise Surveys* collect both subjective and objective data about the 'constraints facing firms' and 'their impact on productivity, investment decisions, and employment decisions'.[2] Data are collected from firms inside each country every two to three years, depending upon 'the country, the updates needed, and requests received' (RRU, personal communication, 2005).

These sources appear to offer legal researchers, especially those on low budgets, empirical data sets of impressive size, scope and depth and validity. An example of the kind of global comparisons that can be made is set out in Table 1.

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[2] Enterprise surveys incorporate two earlier forms of investor perception indicators: World Business Environment Surveys and Investment Climate Surveys. The World Business Environment Survey data are still freely accessible at: http://info.worldbank.org/governance/wbes/front.htm.

Table 1: Legal indicators for India, as compared to China

Starting a business in India takes 89 days and 49.5% of per capita income China better: about half as long and one third of the cost (*Doing Business*, 2004)
Senior manager time spent complying with Indian regulations: 14.41% China worse: about 10% more time (*Enterprise Survey*, 2002)
Firms feeling Indian bureaucrats interpret regulations consistently, predictably: 35.89% China better: nearly double are confident (*Enterprise Survey*, 2002)
Respondents confident Indian court will uphold contract and property rights: 70.63% China better: about 12% more are confident (*Enterprise Survey*, 2002)

However, a major obstacle to recycling World Bank data is lack of reliable access to the raw product. Historically, the Bank has set an excellent example by freely sharing its data both generally and in respect of legal issues. However, this generosity seems to be in peril. *Enterprise Survey* data are no longer freely downloadable from the website. Instead, an application for the data must be made, including an outline of the project and a signed confidentiality agreement. This development is very regrettable as it places a barrier to using the information. As one former senior Bank official said to me in a 2006 interview, the restrictions reflect 'a very Wolfowitzian version of transparency'.

Furthermore, during the course of my research I have discovered a quite extraordinary disregard for accuracy in the publication of these figures. In February 2005 I generated a 'Custom Query' for the 2002 Investment Climate Survey figures for India on the Bank's website. On January 17 2007 I returned to compare the 2002 figures with the most recent 2006 figures (now named the Enterprise Survey). The 2002 and 2006 data sets generated in 2007 were identical, to two decimal points. Obviously something was wrong. Furthermore, the 2002 figures printed out in 2005 were radically different to the 2002 figures obtained in 2007. When I returned to the site a few days later on January 23, I found that matters had changed once more. The new figures for 2002 and 2006 were different from each other, from the January 17 set, and from the 2005 set. When I notified the RRU of the problem they acknowledged that there had been a 'bug' in the system that was now fixed. On January 25, I found that while the initial problems had been fixed, new ones had appeared. The data set was clearly in an alarming state of flux and I have not relied on it since. As no reference to these problems can be found on the website, it is a matter of concern that the erroneous data sets may have provided the basis for PhDs, analyses, and indeed even policy changes.

Finally, problems arise in the context of aggregated data sets. For example, the 'Rule of Law' variable produced as part of the Governance Indicators is, like all the Governance Indicators, a composite of several other indicators produced by different organisations. Its name suggests that it refers to matters such as the extent to which the law is consistently and universally applied. In fact, as Davis (2005) notes critically, and a collector of the data noted cheerfully, it is composed primarily of measures of respect for property rights.[3] This is perhaps the result of

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[3] For the comments of the leaders of the governance projects see video of seminar launching Governance Matters IV at http://info.worldbank.org/etools/BSPAN/EventView.asp?EID=746. It should be emphasised that the leaders of the Governance Matters project under which the indicators have been collected, Daniel Kaufmann and Aart Kraay, adopt a

the fact that the data were collected by economists, for whom property rights are the central aspect of law. For a lawyer, the spread of issues implied by the phrase 'rule of law' is of course far wider.

In the last ten years we have gone from knowing nothing of any significance about legal systems and foreign investment to having a lot of information on the subject. That information might be recycled on equal terms by thousands of researchers rich and poor, and of every political persuasion. For this we have the World Bank to thank. But information cannot contribute to knowledge unless is presented in a systematic, transparent and accessible fashion and in this respect the Bank has more work to do or, increasingly, to undo.

Reduce

The second method by which we can seek to reduce information overload and knowledge deficit is to limit methodological complexity. Before designing an elaborate statistical test—such as the ever popular, and more frighteningly easy to initiate, regression exercise—we should see what we can discover from basic information such as averages, standard deviations and error bars.

Much progress can be made at that basic level and, as a rule of thumb, any elaborate tests we perform on data should be carefully tested against what this basic examination leads us to expect. For example, in an earlier study of legal system indicators and foreign investment flows in South Asia, the US and the UK such a basic examination revealed that the margins of error for one data set were so large as to erase differences among South Asian indicators which initially appear to be significant. A second data set was found to produce completely counter-intuitive results with the legal systems of India, Pakistan and/or Bangladesh scoring 'better' than the US and/or the UK on each indicator. Finally,

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refreshingly generous, transparent and cautious approach to their data and analysis. As they themselves note, problems occur when these data and analysis are applied by others. See for example Kauffman and Kray, 2002, p. 6.

a comparison of related indicators from three different data sets revealed that they were in conflict. The three data sets outlined above were found to be, separately and collectively, unsuited to the task of discovering whether legal systems are a determinant of foreign investment, and if so, what constitutes an attractive legal system. For example, they do not represent the necessary perceptions and realities of the legal system, and they are internally inconsistent (Perry-Kessaris, 2003). Thus the data were revealed to be inappropriate before the seductive forces of regression analysis were activated.

Reflect

When we do not have the time, skills or opportunity to conduct our own analysis of data collected by another, we must rely on the analysis of others. Indeed, an emphasis on recycling would seem to recommend such a course of action. However, it is vital that in so doing we take account of the context within which the data were collected and analysed. World Bank analysis of the relationships between legal systems and foreign investment presents an excellent example.

Law and legal institutions are subject to the attentions of a number of departments in the World Bank.[4] These departments compete with each other, and with other institutions, for prestige, resources and borrowers, all the 'while doing little to reflect on [the] results' of their projects (Santos, 2006, p. 291). The most influential voice within the Bank in respect of law is the Private Sector Development Group which is responsible for the Rapid Response Unit and its *Doing Business* and *Enterprise Survey* data.

Since 2002, the Rapid Response Unit has produced Investment Climate Assessments that analyse 'investment climates' at national and sub-national

[4] The Legal and Judicial Reform Group works on reforming laws and courts, and is in direct competition with the Public Sector Unit which also works on judicial reform. The World Bank Institute produces governance indicators and engages in training programmes, for examples for members of the judiciary(Santos, 2006, p. 291).

level.[5] As the following evaluation of the 2004 Investment Climate Assessment for India demonstrates, 'investment climate' is a portmanteau phrase that does not adequately distinguish between law, politics, economy and infrastructure. It thereby disguises the possibility that legal systems might be of no, limited, or even perverted, significance to investors.

The 2004 Investment Climate Assessment of India promises conclusively to answer questions such as 'how much do [investors] care about the incidence of corruption, or the cost of bureaucratic hassles, or the prevalence of crime before picking a location for a project?' (World Bank, 2004b, p. 5). In fact, it does no such thing. It begins with rapid-fire assertions that the legal system matters to investors, stating that, when contemplating where to locate within India, investors 'consider specific aspects of the local investment climate' such as the 'cost of business regulation', corruption, and access to land, and that they choose their eventual location only 'after estimating' these legal costs and comparing the estimated costs in other locations (World Bank, 2004b, pp. iii and 6). This rather precise declaration appears ridiculous when placed next to the quiet admission made further into the Assessment that just 'a small proportion of firms make their location choices based on a location feasibility report comparing attributes across states.' Buried in a footnote is an elaboration of this pseudo-detritus: '70 percent of responding firms do not base location decisions on a location feasibility report' (World Bank, 2004b, p. 26). In truth, investment climate cannot even be an *important* factor for this substantial majority of investors, let alone a *determining* factor.[6] It is encouraging to see that the Bank has begun to document

[5] These assessments draw on a tangled and opaque web of internal and external data sources, including Doing Business and Enterprise Surveys.

[6] This corresponds with my own findings in Sri Lanka, where less than 50 percent of foreign investors responding to a postal survey reported making any pre-investment investigation of the legal system, and less that a quarter reported making what might be considered to be an in-depth investigation (Perry, 2001). And in Bangalore in 2003, a broad range of interviewees suggested to me that the legal system was not of overwhelming importance for investors in deciding where to invest so while they might make a pre-investment investigation, it

the incidence of pre-investment investigations, but the results must be put to more fruitful use.

There are two ways to identify what investors want: by asking directly, or by inference (World Bank 2004b, pp. 24 and 27). The Assessment makes a mess of both. First it tries to ask, using that old chestnut, the obstacles method. Respondent investors are requested to rate the level of 'obstacle' posed to their operations by a certain feature of the legal system, for example, corruption as 'major', 'severe', 'minor', 'no' and so on.[7] These responses are used to infer and rank investors' priorities for reform. But what does it mean when a respondent indicates that a particular issue is 'no' obstacle? It may be that the legal system offers, for example, certainty, simplicity and low corruption, and that is attractive to that investor; alternatively the legal system may offer uncertainty, complexity and high corruption, but the respondents may feel that it does not impact on them, or they may even prefer it that way. The resulting data are, as anticipated, confusing: 'there are considerable restrictions on the use and transfer of land in India', but only 10 percent of respondents indicated that it was a severe obstacle to doing business. The authors of the Assessment seem unsure of whether the disparity was due to respondents' ignorance of the restrictions on the transfer of law, or the irrelevance to investors of this particular issue (World Bank, 2004b, p. 20). A former World Bank Country Director for India remarked in a 2006 interview that the use of data based on the perceptions of investors had given commentators an excuse to 'beat up the Bank by saying "look at this methodology, it's useless" rather than focussing on what was wrong with them.' Although enthusiastic about the investment climate project, he had argued strongly inside the Bank that the investment climate indicators methodology needed to be revised—data based on perceptions were 'frankly misleading' and

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would not be the main criterion on which the decision was based (see Perry-Kessaris,2004).

[7] This method was applied by Borner, Brunetti and Weder (1995), whose work on political credibility provided the foundation for much of the Bank's empirical work in this field (Perry, 2001, p. 61).

should be ‘very tightly ring-fenced’ in order to preserve the credibility of the data set as a whole.[8] His resistance appears to have been futile.

Next respondent investors were asked to rank Indian states in order of attractiveness. From these rankings, the elements of an attractive investment climate are inferred. The results are intriguing. States ranked by investors as relatively ‘better’ investment climates, tended to have what the Bank would consider to be relatively *poor* legal systems. For example, the frequency of inspection visits, management time involved in complying with regulations, costs of regulation, the duration of customs clearance and levels of corruption were all higher in supposedly ‘better-climate’ states. The Assessment reasons that these States were rated ‘better’ solely on the basis of their physical infrastructure, especially power supply (World Bank, 2004b, p.31). This would mean that the legal system is not at all relevant, which certainly does nothing to support the dominant theory. It also means that to lump together such disparate areas as infrastructure, economic policy and the socio-legal system under the term ‘investment climate’ is aggregation to the point of obfuscation. Naughtily, the executive summary still insists on the general importance of the investment climate as a whole.

There is another possible interpretation of these figures, one that jars horribly with the dominant investment climate discourse. This interpretation is not referred to, even obliquely, in the Assessment. Investors might be attracted to these states *because* they have ‘poor’ legal systems. The Assessment authors themselves noticed that all was not well between investment climate theory and Indian reality, highlighting ‘counterintuitive’ findings relating to corruption: investors locate where profits are high, and in India these tended to be places

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[8] His attempt to resolve misunderstandings about the indicators is documented in the English language press (*Times of India*, November 4, 2005).

where corruption was high.[9] But the Assessment undertakes no meaningful reflection on the significance of its findings. Without pausing for breath, it bowls on to state categorically that ‘regulations and corruption are important determinants of business locations’ and that cities with ‘lower regulatory burden are likely to receive more investment and have higher shares of manufacturing activity’ (World Bank, 2004b, pp. 37-8). The whiff of *eau de* hypothesis confirmation wafting through the 2004 Assessment was foreshadowed by Harilal and Basu (2002), who observed that the 2002 Assessment of India was ‘in a hurry to prove certain preconceived ideas on investment climate’ which ‘do not follow from the data set assembled’.

The Assessment concludes, weakly, that:

> The case for further improvement in the investment climate in low-growth and low-FDI states is not really that their investment climate is worse than the rest of India, for which there is no evidence, but rather that it must be better, because a better investment climate is the only way of making up for disadvantages over which the state has no control (World Bank, 2004b, p. 56).

This seems to mean that the Indian investment climate is satisfactory, but could, unlike other constraints—such as geographical location or natural resources--feasibly be improved. But this conclusion is only justified if the investment climate is something that is important to investors, and if the investors’ vision of an attractive investment climate aligns with the Bank’s. These conditions are (at best) not proven. In fact the Assessment itself takes the argument some way in the opposite direction.

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[9] One explanation offered by the Assessment is that investors actually ‘perceive informal payments as a transaction cost’ that is preferable to undergoing the inspection itself (World Bank, 2004b, p. 38). So, one aspect of a ‘poor’ legal system (corruption) can adequately compensate for another aspect of a poor legal system (invasive regulation).

Conclusion

> 'There is something fascinating about science. One gets such wholesale returns of conjecture out of such a trifling investment of facts.'
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> Mark Twain

There is no question that the Bank has over-stated its empirical case that legal systems are important to foreign investors. A dubious methodology does not preclude a researcher from stumbling upon an accurate conclusion. Perhaps foreign investors are strongly attracted to rule-based legal systems. But we do not yet have proof that this is the case, and the Bank ought to start trying to get some, or at least stop purporting already to have done so. In the meantime, in this field as in others, we must seek to recycle, but only with caution and reflect, reflect, reflect.

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